Office of Chief Counsel
Internal Revenue Service

memorandum

CC:NER:OHI:CIN:TL-N-5134-00
JEKagy

date:

to: Chief, Examination Division, Ohio District
Attn: Ron Meyer

from: Assistant District Counsel, Ohio District, Cincinnati

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subject: **CORP A**
Section 332 Issue

DISCLOSURE STATEMENT

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This memorandum is a follow-up to the Sept. 6, 2000 memorandum to file generated after our first meeting with the [redacted] - [redacted] CORP A audit team. On [redacted], we received a statement of fact and associated appraisals relating to the second issue raised at our meeting, namely, the claim of a capital loss associated with the liquidation of certain CORP A foreign subsidiaries.

ISSUE:

Whether the Service can deny the recognition of the losses claimed by the taxpayer on the two corporate liquidations.

CONCLUSION:

While it is premature to suggest that facts will be found supporting the disallowance of the losses claimed, you have the right to scrutinize the steps utilized to accomplish the two liquidations to determine whether the form chosen by the taxpayer comports with the substance of the transaction.

FACTS:

Prior to [redacted], CORP A directly and, through its domestic subsidiaries, indirectly owned [redacted]% of CORP A [redacted] ("[redacted]"), a [redacted] holding company, which in turn owned [redacted]% of a [redacted] operating company known as CORP A [redacted] ("[redacted]").[1] In [redacted], [redacted] issued new voting stock to CORP A Investments ("Investments"), a Canadian subsidiary owned [redacted]% by CORP A. The newly issued stock diluting CORP A's direct and (domestic) indirect ownership interest in [redacted] to [redacted]%. In [redacted], Investments purchased newly issued voting stock in [redacted] ("[redacted]") another [redacted] holding company formerly indirectly owned [redacted]% by CORP A. Investments' purchase diluted CORP A's ownership interest in [redacted] to [redacted]%. In [redacted], [redacted] purchased newly issued voting stock in [redacted], further diluting CORP A's direct and indirect ownership in [redacted] to [redacted]%. Several days later, [redacted] was liquidated.

The only asset owned by [redacted] was its [redacted]% interest in the stock in [redacted]. In addition to its $[redacted] initial equity interest in [redacted], [redacted] had "loaned" [redacted] $[redacted]. While reflected on [redacted]'s [redacted] books as a loan, the $[redacted] was carried on the U.S. books for GAAP and tax purposes as an additional capital contribution. An appraisal of [redacted] reflected a value on the date of [redacted]' liquidation of only $[redacted]. CORP A's basis in [redacted] was approximately $[redacted]. Upon [redacted]' liquidation, CORP A was treated as having received its proportional share of the value of [redacted] CORP A claimed a loss of $[redacted] on the liquidation of [redacted], calculated as the difference between its basis in [redacted] and the value received upon liquidation.

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[1] Attached are charts illustrating CORP A's initial ownership interest and its subsequent interests after the various transactions described hereinafter.

In [redacted], [redacted] was also liquidated. [redacted]'s only asset was its [redacted]% equity interest in [redacted], an equity interest which had a cost basis to [redacted] of $[redacted]. In addition to its initial equity interest in [redacted], [redacted] had "loaned" [redacted] approximately $[redacted]. [redacted] reflected this amount on its Brazilian books as a loan, but the "loan" was carried on the U.S. books for GAAP and tax purposes as an additional capital contribution. An appraisal of [redacted] reflected a value of $[redacted] on the date of [redacted]'s liquidation. [redacted]'s basis in [redacted] was approximately $[redacted]. Upon [redacted]'s liquidation, CORP A received only its proportional share of the value of [redacted] and CORP A claims a loss of $[redacted], calculated as the difference between its basis in [redacted] and the value received upon its liquidation.

ANALYSIS:

As a general rule, distributions in complete liquidation of a corporation are taxable to the shareholder under section 331 to the extent that the fair market value of the distribution exceeds the shareholder's basis in the stock. 11 J. Mertens, The Law of Federal Income Taxation § 42.01 at 3 (1990). An exception to this general rule is found at section 332 which provides that property received under certain circumstances by one corporation in a complete liquidation of the stock of another corporation does not result in either gain or loss to the recipient corporation. Application of the exception depends upon, among other things, whether the recipient owns at least 80% of the liquidating corporation. Section 332(b).

To determine whether a consolidated group member, such as the instant taxpayer, satisfies the 80% ownership requirement of section 332(b), the stock attribution rules of § 1.1502-34 must be applied. See Rev. Rul. 74-598, 1974-2 C.B. 287, as amplified by Rev. Rul. 75-383, 1975-2 C.B. 127 and modified by Rev. Rul. 89-46, 1989-1 C.B. 272. Under those rules, to determine the stock ownership of any member of a consolidated group, the stock of all of the members of the affiliated group is aggregated.

Applying the affiliated group rule on the dates of the liquidations,[2] the taxpayer's affiliated group did not hold the

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[2] Although unlikely to result in an issue, you should inquire into the dates of the adoption of the plans of liquidation of the two subsidiaries. If the dates of adoptions came before the affiliated group's ownership interest was reduced below 80%, an issue may exist. Section 332(b)(1). See Crescent Oil Corp. v. Commissioner, T.C. Memo. 1979-26 (section 332 did

requisite 80% ownership interest. Here, there is no question that the taxpayer deliberately manipulated the ownership of the eventually liquidated subsidiaries to arrive at an affiliated group ownership interest of less than 80%. The taxpayer assured its "failing" the 80% test by orchestrating the purchase of the liquidating subsidiaries' stock by a controlled foreign (Canadian) corporation, a corporation outside the taxpayer's affiliated group. At issue is whether the taxpayer should be permitted to reduce its affiliated group's ownership interest in the liquidated companies so as to avoid section 332.

Similar issues have been litigated numerous times. One of the earliest cases is Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945). There, the parent reduced its ownership interest below 80% in order to claim long term capital losses on the liquidations of two of its subsidiaries. The Court allowed the loss recognition based upon the finding that the stock reduction was attributable to a bona fide auction of the stock to a third party individual, albeit, the parent corporation's treasurer. Similarly, in Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956), the Court allowed the sale of a 20.5% interest in a subsidiary to reduce the parent's interest in the subsidiary, thus allowing the recognition of a loss upon the subsidiary's liquidation, notwithstanding the Court's finding that the sale was "motivated solely by tax considerations and were made in a friendly atmosphere to friendly people." Granite, 238 F.2d at 674.

The holdings of these types of cases were generally summarized by the Tax Court in Riggs v. Commissioner, 64 T.C. 474 (1975), acq., 1976-2 C.B. 2, when it stated:

> Based on the legislative history of this section and prior judicial decisions, we conclude that section 332 is elective in the sense that with advance planning and properly structured transactions, a corporation should be able to render section 332 applicable or inapplicable.

Riggs, 64 T.C. at 489.

While at first blush such language may appear sufficiently broad enough to control your situation, such a conclusion would be an overstatement and a misreading of the cases. The language

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not apply since the parent did not own the necessary 80% interest until after the adoption of the plan of reorganization). See also, Madison Square Garden Corp. v. Commissioner, 58 T.C. 619 (1972), aff'd and rev'd, 500 F.2d 611 (2d Cir. 1974).

quoted above does not require that the Service recognize every transaction devised by taxpayers as legitimate. To the contrary, the Service always has the ability to scrutinize the legitimacy of any transaction and to satisfy itself that the substance of the transaction matches the transaction's form. As noted by the Tenth Circuit in Associated Wholesale Grocers, Inc. v. United States, 927 F.2d 1517, 1525 (10th Cir. 1991):

> The nonrecognition mandated by § 332 is not optional at the election of taxpayers within the reach of that section. 'Section 332 is not elective. Nonetheless, a number of planning possibilities are evident which may allow a corporation to avoid the application of Section 332.' 11 J. Mertens, The Law of Federal Income Taxation § 42.55 at 142 (1990). Steps taken by the taxpayer, however, are not immunized from '[t]he question ... whether the transaction under scrutiny is in fact what it appears to be in form.'

From the above, we conclude that the Service has the right, duty and obligation to inquire into the substance of a transaction, to probe into whether the form and substance agree, and to determine whether other agreements or "behind the scenes" arrangements obviate the legitimacy of the transaction at hand. Only if the Service determines that the sales at issue are true, arm's length sales and that no side agreements exist which alter the substance of the transaction must the Service respect the transaction.

In your instance, obvious questions exist regarding: (1) the business purpose of the various steps in the transactions; (2) the dates the plans of liquidation were adopted; (3) the arm's length nature of the stock sales themselves; (4) the ability of the purchaser to satisfy its indebtedness; (5) the source of the funds used for the transactions; (6) the treatment and effect, upon liquidation, of the "loans" to [redacted] for [redacted] tax purposes; and (7) the existence of any side deals, stock repurchase agreements, hold harmless arrangements and other similar arrangements which may alter the apparent substance of the transactions. The Service should also consider having an engineer or an outside expert review and opine on the legitimacy of the underlying assumptions reflected in the appraisals of [redacted] offered by the taxpayer in support of its claimed losses.

Needing to satisfy itself that the steps taken by the taxpayer have substance consistent with their form, the Service has the right to scrutinize each step taken by the taxpayer even though from the factual statement recited above we are unable to identify specific facts which suggest that the form chosen by the

taxpayer for the transactions is a sham. In determining the substance of the transactions, the Service should consider obtaining and reviewing the internal planning documents generated by or for the taxpayer concerning these liquidations, and carefully ascertaining whether the substance and the form of the transactions coincide.

If we can be of assistance in this matter in the future, please contact the undersigned at 684-3211.

MATTHEW J. FRITZ
Assistant District Counsel

By: _____
JAMES E. KAGY
Special Litigation
Assistant

Attachments:
As stated.